United States Court of Appeals

for the Second Circuit

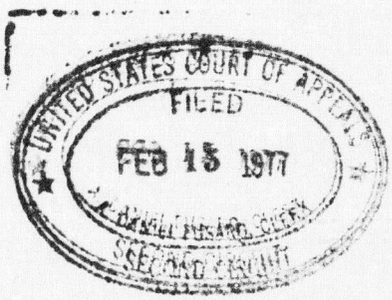
APPELLANT'S REPLY BRIEF

76-5039

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Signed copy

In the Matter of REA HOLDING CORPORATION, THE EXPRESS COMPANY, INC., REA EXPRESS, INC., f/k/a Railway Express Agency, Inc., REXCO SUPPLY CORPORATION, Bankrupts.	Docket No. 76-5039
MATTHEW E. MANNING, ANTHONY SATRIANO, DANIEL S. GILHULY, VINCENT PONTILLO, WILLIAM R. WEGL, EDMUND F. NOVITSKI, EDWARD J. COX, ANTHONY J. JANUZZI, CHARLES F. McGOVERN and JAMES J. KILCOYNE, petitioning creditors, Appellants, v. C. ORVIS SOWERWINE, Trustee in Bankruptcy, Appellee.	
BROTHERHOOD OF RAILWAY, AIRLINE AND STEAMSHIP CLERKS, FREIGHT HANDLERS, EXPRESS AND STATION EMPLOYEES, Intervenor.	



APPELLANTS' REPLY BRIEF

WISEHART, FRIOU & KOCH
150 East 42nd Street
Suite 420
New York, New York
(212) 557-8800

Dated: New York, New York
February 15, 1977

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- -x

In the Matter of :

REA HOLDING CORPORATION, :
THE EXPRESS COMPANY, INC., :
REA EXPRESS, INC., f/k/a : Docket No. 76-5039
Railway Express Agency, Inc., :
REXCO SUPPLY CORPORATION, :

Bankrupts. :

- -x

MATTHEW E. MANNING, ANTHONY SATRIANO, :
DANIEL S. GILHULY, VINCENT PONTILLO, :
WILLIAM R. WEGL, EDMUND F. NOVITSKI, :
EDWARD J. COX, ANTHONY J. JANUZZI, :
CHARLES F. McGOVERN and JAMES J. :
KILCOYNE, petitioning creditors, :

Appellants, :

v. :

C. ORVIS SOWERWINE, Trustee :
in Bankruptcy, :

Appellee. :

- -x

BROTHERHOOD OF RAILWAY, AIRLINE AND :
STEAMSHIP CLERKS, FREIGHT HANDLERS, :
EXPRESS AND STATION EMPLOYEES, :

Intervenor. :

- -x

APPELLANTS' REPLY BRIEF

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v.	:	
C. ORVIS SOWERWINE, Trustee in Bankruptcy,	:	
Appellee.	:	

REPLY BRIEF ON BEHALF OF APPELLANTS

I

A Receiver Should Be Appointed

The Trustee's brief opposes the application for the appointment of a receiver, devoting only one page to the discussion of that important point. (p. 53) The one-page discussion wholly ignores the Supreme Court's Bankruptcy Rule 201

which provides that a receiver may be appointed when necessary in the best interest of the estate "... to afford representation to the estate in an action, adversary proceeding, or contested matter when no trustee has qualified or the interest of the trustee may be adverse to that of the estate." (Emphasis added.)

The verified application for the appointment of a receiver herein, signed by over 100 creditors who are former employees,* relies precisely upon that ground in pointing out the importance of a more balanced presentation regarding the possibilities for the bankrupt in the proceedings before the Interstate Commerce Commission. It also asserts that the liquidation posture of the Trustee and his counsel is inflicting irreparable injury upon REA's very valuable rights, the bankrupt's estate, and the creditors of REA generally, and that "serious conflict of issues ... have arisen with respect to the Trustee and his counsel...." (Manning App. 56-57)** For the purpose of this appeal, these assertions from a verified petition regarding which no testimony was permitted, must be deemed to be true in the same manner as the allegations of a complaint which has been dismissed.

---

*An offer of proof was made that Mr. Devlin would testify, based upon his knowledge of the desires of the 8,000 former employees, that they would all support the receiver application as well as the Chapter X petition. (Manning App. 139)

**For convenience the Appellants' Appendix is referred to herein as "Manning App." and the Trustee's Appendix is referred to as "Trustee's App."

The short shrift given by the Trustee to the application for the appointment of a receiver is premised upon two related factual errors:

First is the bald assertion that it would be desirable for the present Trustee to remain in office "until his successor is appointed" in the interest of "orderly transition." (Br. 53)

Second is the related proposition that "the Trustee has not committed nor is he accused of any wrong-doing or negligence in his trusteeship." (Br. 48)

We submit that such a position can not be maintained on behalf of a Trustee whom the Interstate Commerce Commission, in terminating REA's authorities potentially worth $50 to $100 million dollars, found to be responsible for extended operational misconduct and legal violations. (Manning App. 440-441) Further, the Commission specifically premised its decision upon the liquidation status of REA -- a status which the Trustee has stubbornly maintained despite repeated contrary advice given him by Mr. Nogg and others. (Manning App. 442)

A Trustee who failed to demonstrate to the Interstate Commerce Commission "that there is anyone capable of knowledgeable and responsible management of the purported motor carrier operations under REA's authority," and about whom the ICC found that "no one in the management of Rexco is familiar with the overall scope or limitation of REA's operating authority," is

hardly in a position to maintain before this Court that he has "not committed nor is he accused of any wrong-doing or negligence in his trusteeship." (Br. 48)

The ICC's findings quoted above are found in the appendix to our initial brief, pages 440-441.

The Commission denied various motions for reconsideration by an order dated January 27, 1977, finding, among other things, that "there is substantial and convincing evidence of record to support the finding that the involved operations were totally unlawful, demonstrating, at the very least, a lack of supervision or such disregard of statutory regulation irrespective of evil intent or erroneous advice, constituting willful behavior on the part of [the Trustee]." (Emphasis added; p. 4.)

While we do not agree with all of the ICC's findings, we submit that they certainly raise a serious question about the behavior and qualifications of the Trustee. Further, the taint placed upon REA's authority by the Trustee's activities clearly demonstrates the desirability of prompt action on the application to appoint an independent receiver so that a new face may be put upon the bankrupt's dealings with that important agency, the Interstate Commerce Commission.

The adverse effect of the Trustee's pro-liquidation posture in the ICC proceedings was specifically referred to in the application for the appointment of a receiver (Manning

App. 56). This same problem was put in sharp focus, in the context of a request for a proper determination of the conflict of interest issue, by this firm's memorandum to the Bankruptcy Court of June 14, 1976 (Manning App. 237-238):

> "... since adjudication it has become apparent that there are policy differences between those who want a precipitate liquidation of the express business and those who think that a greater realization upon its valuable operating rights will be produced for the creditors through the continuing operations of a 150-year old American transportation institution.
>
> The application prepared by bankruptcy counsel in support of the instant motion itself reveals their liquidation attitude.***
>
> Others -- those who in our view are more experienced in transportation -- have advised that profitable and inclusive express operations should be restored on a step-by-step basis, and that by doing so the rights and authorities are more likely to be preserved and protected. It has been estimated that those authorities if made permanent would have values in the range of $50,000,000 to $100,000,000.
>
> * * * *
>
> With the existence of (1) differing views as to the desirability of the meat-ax approach to the liquidation of REA, and (2) certain interests -- both competitors and litigation defendants -- having motives for promoting the dismemberment of the express business for reasons unrelated to what is otherwise in the best interests of REA's creditors, the importance to the bankrupt estate of having a proper judicial determination of the conflict issue at this time seems clear."

II

The Failure to Hold a Creditors' Meeting is Totally Ignored

The brief on behalf of the Trustee assumes that the Trustee has been qualified in office (Br. 31). However, this ignores - as does the brief in its entirety - the explicit requirement of both the Bankruptcy Act and the Supreme Court's Bankruptcy Rules that there must be a meeting of creditors after adjudication. The provisions relating to this requirement are set forth at pages 60 and 61 of our initial brief. As shown in Section 44a of the Bankruptcy Act (11 U.S.C. §72), one of the most important functions of such a meeting, following adjudication, is to appoint the Trustee or if one has been appointed, to consider his qualifications. This would be particularly important in view of a conflict of interest issue which was not revealed when, seven months prior to adjudication, and before thousands of creditors had filed their proofs of claims, Mr. Sowerwine, who was not even present, was chosen standby trustee.

Nor can the Trustee be heard to argue that no such meeting was required because of a meeting seven months earlier while REA was operating as a debtor-in-possession. First, as pointed out in our brief, the statutory mandate is clear: there must be a meeting after adjudication, and there has been no such meeting. The difference between an operating debtor-in-possession, under the control of the former management, and an

adjudicated bankrupt, whose interests are those of the creditors alone, is too great to permit the former meeting to be used as justification for evading the clear statutory mandate for a meeting following adjudication.

Second, in Mr. Sowerwine's application for the appointment of bankruptcy counsel, dated November 6, 1975, he states, inter alia, that he will require the services of such counsel "for the examination of the bankrupt at the first meeting of creditors...." (Emphasis added.) Thus the Trustee cannot be heard to contend that such a meeting is not necessary, or that he never contemplated calling such a meeting.

There are approximately 30,000 creditors in this bankrupt estate. Many of them are employees who have been thrown out of work. Information provided to them to date has been woefully inadequate. Stockholders in public companies customarily receive much more information concerning their interests than has been made available in this bankruptcy. There is absolutely no excuse for the cloak of secrecy which has enveloped the administration of this bankrupt estate.

The application for the appointment of a receiver was based in part upon the chaotic condition of the files holding the creditors' proofs of claim (Manning App. 58). Creditors cannot participate in any meaningful way in the bankrupt estate, other than by hiring expensive attorneys, an expedient beyond the reach of thousands of former employees who are without jobs,

if the required meetings are not held and the adequate provision is not made for the paperwork relating to their interests.

In the record in this case, it can not be disputed that the proofs of claims of the 30,000 creditors are in a condition reminiscent of the "back office" mess on Wall Street some years ago. The condition is described in detail by Mr. Dermott Noonan, a distinguished independent accountant, beginning on page 301 of the appendix to our initial brief. The chaotic condition is further described in the testimony of Cheryl Stelter on October 13, 1976, who confirmed the accuracy of Mr. Noonan's report based upon her personal familiarity with the files and stated that thousands of proofs of claim on behalf of creditors were not sent to the computer company responsible for sending out notices because, as she was told by a responsible clerk in the Bankruptcy Court, "it was too expensive and the truseee didn't want to spend the money for it any more." (Manning App. 414)

Whatever the cause, the Bankruptcy Court found, as recently as October 15, 1976, nearly a year after REA was adjudicated a bankrupt, that notices had not been sent out to over 4,000 creditors. (Manning App. 421)

Until this is straightened out, it is obviously impossible for the creditors to participate in the affairs of the bankrupt estate in the manner contemplated by the Bankruptcy Act, and the holding of a creditors' meeting is stymied.

Thus, (1) the findings regarding the derelictions that took place under the Trustee's administration of the bankrupt estate by the Interstate Commerce Commission, (2) the jeopardy into which he has placed REA's valuable authority despite repeated warnings, (3) his willful refusal to call a meeting of creditors, in violation of duties specifically imposed in the Bankruptcy Act, and contrary to his general obligations as a fiduciary as well as his own representations to the Bankruptcy Court on November 6, 1975, and (4) his allowing a "back office mess" to develop regarding the proofs of claims, all refute the contention that there has been no wrong-doing or negligence in Mr. Sowerwine's trusteeship. (Br. 48), and constitute circumstances in addition to the Chapter X and adverse interest issues supporting immediate action for the appointment of a receiver.

The effort by the Trustee to divert attention from the application for the appointment of a receiver is clear from a review of the record as well as his brief in this appeal. Although the Trustee admits that, at the time the application came on, this firm asserted that only the application for a receiver should be considered (Br. 17), the filing of the duplicate Chapter X petition is attributed to an off-the-record order of Judge Pollack. However, what the Trustee's brief fails to disclose is that the entire maneuver stemmed from his own counsel's insistence that the duplicate Chapter X petition be filed.

(Trustee's Aff. 10/22/76, p. 28.) By this tactic, what was to have been a hearing on the receiver application, and the strong showing that a receiver should be appointed in the interest of the bankrupt estate -- entirely apart from considerations relating to the Chapter X petition -- was successfully obfuscated.

The efforts of the Trustee to distract attention from the merits of the case for the former employees have now taken the further form of a motion to disqualify this firm. The use of the disqualification proceeding to create prejudice with respect to this appeal is evident from the Trustee's brief (such as the assertion "that such conduct violated the provisions of the Code of Professional Responsibility of the American Bar Association and was conduct unbecoming a member of the bar as that term has been defined by this Court and the District Court." (Br. 2)). The disqualification was made <u>following</u> the filing of this appeal but deals with substantially the same issues involved in the appeal. The motion was made in the Bankruptcy Court, which clearly, under the decisions, had lost jurisdiction over those issues, and resulted in a series of ex parte orders. One such order was a so-called preliminary injunction. The Trustee's counsel brandished it about at the pre-argument conference with Mr. Fensterstock of this Court, when we first learned of its existence. This injunction was subsequently vacated by Judge Motley as having been improperly issued.

The Trustee's brief substantially misstates the

circumstances under which, upon the direct recommendation of Messrs. Kahn, Wallace, Bell and Angel of his bankruptcy counsel, who themselves have disabling conflicts of interest, he requested on April 13, 1976, an opinion from Mr. Friou of this firm concerning his conflict of interest problem. (Br. 23-24)

The Trustee's brief states as "most important" the testimony of Mr. Nogg on November 17, 1976, that this firm had been retained to represent the employee interests on March 24, 1976, and further states that the significance of the date is due to the fact that, when the Trustee asked for our opinion on April 13, 1976, on the conflict of interest issue, he "had no knowledge whatsoever of such retention." (Br 22)

This statement is flatly untrue. On or about March 17, 1976, Messrs. Nogg, Sowerwine and Devlin agreed that Mr. Wisehart would represent the REAEMCO interests. R. Nov. 17, 1976, pp. 37, 41. Mr. Wisehart did not know of that agreement at the time, but he learned of it in the latter part of March, 1976. R. Dec. 27, 1976, p. 15.

On or about April 7, 1976, Mr. Wisehart was informed by Mr. Sowerwine stating that he had it in mind that this firm would become counsel for REAEMCO. R. Dec. 27, 1976, p. 15. Mr. Wisehart stated that he would comply with Mr. Sowerwine's desires. This understanding was embodied in a memorandum prepared by Mr. Wisehart

and communicated to the personnel of the firm on the same date. R. Dec. 27, 1976, p. 15. Further, it is not denied that Mr. Sowerwine repeatedly demanded the conflict opinion after he stated that he had a conflict of interest in the presence of others at the April 20 meeting when a handshake agreement was reached on the REAEMCO proposal, and the representation of those interests by this firm was specifically ratified and approved by Mr. Sowerwine and his bankruptcy counsel. Thereafter, on several occassions, even as late as May 3, 1976, Mr. Sowerwine repeated his request for the conflict of interest opinion from this firm while he remained undecided as to which proposal he would finally recommend. (R. Nov. 10, 1976, pp. 56, 68, 70, 88; Nov. 17, 1976, pp. 26, 30, 58; Dec. 16, 1976, p. 43.)

The impression that the Trustee was dangling a favorable decision on the REAEMCO proposal, as well as action on our then pending retainer as special counsel, as bait for a favorable decision on the conflict of interest question occurred to us as a distinct possibility. Because of our past personal relationship with the Trustee, we did not wish to draw that inference and we did not desire to grasp the thorn of nettles presented by him. However, in view of the Trustee's repeated

demand for the opinion, at a time when it is not denied that he knew of and approved of (indeed, requested) our representation of the employee interests, we concluded that we had no alternative,* in view of our duty to the bankrupt estate, to the employee interests and to the Court as well, but to set forth our views, taking care, however, to see that they were confirmed by the independent view of Professor S. Chesterfield Oppenheim, to whom we had submitted the question because of his role as special consultant on REA's major litigation, and who also had advised us on the similar conflict of interest problem of the Trustee's counsel.

The Trustee's brief also misstates the basis of the conflict of interest of the Trustee as being "basically because the Trustee owned less than one-tenth of one percent of the share of Shearson Hayden Stone, Inc. ("Shearson"), a large publicly held company, and the Trustee was an officer of such company. (pp. 22-23) In fact, the Trustee is a Senior Vice President of

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*Judge Weinfeld aptly states the relevant rule in Estates Theaters, Inc. v. Columbia Pictures Indus., Inc., 345 F.Supp. 93, 98 (S.D.N.Y. 1972) as follows:

> "When the propriety of professional conduct is questioned, any member of the Bar who is aware of the facts which give rise to the issue is duty bound to present the matter to the proper forum, and a tribunal to whose attention an alleged violation is brought is similarly duty bound to determine if there is any merit to the charge." (Footnote omitted; emphasis added.)

the company. As such, he has clearly established fiduciary duties to a company that obtains a substantial part of its business (precisely how much has never been disclosed) from its railroad department. These fiduciary duties which the Trustee has to Shearson clearly conflict with his fiduciary duties to this bankrupt estate, entirely apart from the amount of his stock ownership. This conflict is compounded by the fact that the Trustee's bankruptcy counsel have the same conflict of interest. The Trustee's brief says that the Trustee had caused a special inquiry to be made at Shearson concerning its railroad department after his qualification "as to the details of which he had no prior knowledge" (p. 23), but omits to disclose that what prompted the inquiry was the analysis which this firm had given him in February that his bankruptcy counsel were disqualified because of their similar railroad clientele and affiliations.

On the conflict of interest issue, the Trustee's brief relies heavily on a statement that a motion to remove the Trustee had not been made as of August 24, 1976 (Br. 26, 46-47). What that contention overlooks are two basic points:

> First, the Bankruptcy Court had already acted to take the conflict issue under advisement at the time the statement was made, and this firm had already specifically requested a hearing on the issue in that context.
>
> Second, thereafter (1) an application to appoint a receiver was made under Bankuptcy Rule

201 on the specific ground of conflicting and adverse interests, and (2) oral and written motions both were made to disqualify and remove on conflict grounds almost immediately after we learned that the Bankruptcy Court no longer took the position that it had the conflict issue under consideration, and said that it had not been properly raised.

In response to the Trustee's motion to retain Windels & Marx, this firm filed a memorandum dated June 14, 1976 (Manning App. pp. 237 to 241) which said in part:

> "The Court's action in directing that the instant motion be served on this firm for its comments upon receipt from the Trustee or his counsel of our memoranda of May 6 and May 11, 1976, we interpret as an indication by the Court that it now desires to explore the issue." (Manning App. p. 236)
>
> " . . . the importance to the Bankrupt estate of having a proper judicial determination of the conflict issue at this time seems clear." (Manning App. p. 238; emphasis added.)

The memorandum also stated "2 Collier on Bankruptcy 1667 points out that under §2 a (17), as amended in 1938, a bankruptcy court may remove a trustee on its own motion." (Manning App. p. 238)

Our memorandum concluded as follows (Manning App. 239-240):

> "2 Collier 1669 states that the power of removal is less frequently exercised than the power of disapproval. Footnote 6, however, cites three New York District Court cases indicating that the power may be appropriately exercised on the basis of circumstances later coming to the oourt's attention. Moreover, because no meeting of the creditors has been held since adjudication, as pointed out above, it would appear that the initial appointment of the Trustee and bankruptcy counsel should be given less weight than would otherwise be the case. Indeed, the affidavits initially filed, by failing to reveal the existence of the conflicts, would appear to make the appointments voidable.
>
> Actually, we do not think that removal is an issue. If disqualifying conflicts are found to exist, we have no reason for believing that the Trustee would not abide by such determination. In our view, this motion has been brought on by the Trustee because of a genuine and sincere desire on his part to have the issue resolved. Where we depart from the Trustee is on a matter of procedure; we think that under the Bankruptcy Act this Court has the sole responsibility for making the determination he seeks. It seems self-evident that such responsibility should not and can not be delegated to a law firm selected by those regarding whom the conflict is asserted. Further, because the responsibility is this Court's, no purpose would be served by burdening the bankrupt estate with the cost of yet another opinion on the same subject.
>
> As we originally indicated, a more detailed examination of the facts on the conflict issue would be desirable, particularly with respect to the conflict of interest issue involving bankruptcy counsel. Because of the disputed nature of this issue, the importance of the interests involved, and in fairness to all concerned, the necessary factual determinations should be made on the record by this Court with notice to all creditors. See In re Eloise Curtis, Inc., 326 F.2d 698, 701 (2d Cir. 1964), which emphasizes that such a determination should be made "in the light of the particular facts of the case . . . ." If the Court desires to recuse itself on the basis

of active participation in the administration of the bankrupt estate, or because of the press of other matters, we suggest that the issue be assigned to a United States Magistrate for findings pursuant to 28 U.S.C. § 636(b). Cf. S.D.N.Y. Bankruptcy Rule X-7 and General Rule 25(a).

CONCLUSION

The motion should be denied and the conflict issue determined by this Court or assigned to a United States Magistrate for findings on an initial decision."

What we had not seen at the time of the hearing on the motion to retain Windels & Marx was the Trustee's letter of May 17, 1976, a letter dealing with our opinion but filed with the Bankruptcy Court on an ex parte basis, and what we did not know at the time was that Windels & Marx had participated in the authorship of that letter. The letter discusses and relies upon communication with the Judge in chambers, and procedures followed on the conflict of interest issue which it claims were at the Court's direction or suggestion. There is no record of such discussion or the statements by the Judge, and the episode as described by the Trustee in the letter departs materially from our recollection of it. The letter is copied in Manning App. at 296-300. Despite the fact that our firm was involved in the subsequent procedures followed by the Trustee and the further fact that we were present at the March 9, 1976 meeting in question and had prepared the opinions which were transmitted with the May 17 letter, no information concerning the May 17, 1976 letter was given to Wisehart, Friou & Koch. Nor did we receive a

copy until after its existence was disclosed on August 18, 1976, when we asked the Court at a hearing whether such a letter had been written. R. Aug. 18, 1976, pp. 11-13.

The Windels & Marx letter was dated July 30, 1976. It also was delivered to the Court on an ex parte basis. The Trustee's brief incorrectly asserts that the Windels & Marx letter was omitted from the appendix submitted with our initial brief. (Br. 25) It can be found at pages 259-264 thereof together with a detailed affidavit analyzing its mistakes and inaccuracies.

This firm's lack of knowledge concerning the two ex parte letters referred to above is described in the hearing held before the Court on August 18, 1976, when the following colloquy took place (R. Aug. 18, 1976, pp. 11-13):

> "MR. FRIOU: Secondly, there is a letter -- there are two letters in the proceeding which neither my partner nor I have seen.
>
> Yet I think they are fairly fundamental to our interests.
>
> One is a letter from the Trustee to the Court describing the conflict of interest problem.
>
> The second -- and I don't know whether that is under some privilege or not, Your Honor -- the second point is that I understand now that the Windels & Marx firm has given an opinion to the Trustee on the issue of conflict of interest.
>
> We would ask that we may also see that letter in confidence.

THE JUDGE: Well, there has been a letter from the Windel firm. It certainly was delivered to my office.

I don't recall to whom it was directed. It may well have been directed to me, but I see no reason why you shouldn't have a copy of that.

Do you have any objection, Mr. Kahn?

MR. KAHN: I have no objection to giving Mr. Friou a copy of both letters.

THE JUDGE: All right."

In the course of the argument during the hearing on August 18, the Court made the following remarks on what he intended to do regarding the ex parte Windels & Marx opinion letter (R. Aug. 18, 1976, pp. 18-19):

"THE JUDGE: I received an opinion from the Windels & Marx firm which I will be happy to make available to you.

I still have not resolved the problem of the question of conflict of interest on the part of the Trustee.

I am perfectly willing to address that as soon as I have time to write an opinion." (Emphasis added.)

Although the Court indicated that it was studying the Windels & Marx letter, which it had received on an ex parte basis, it refused to consider the information in Mr. Friou's affidavit of August 23, 1976, showing the numerous factual errors in the Windels & Marx letter. (Manning App. 242-258) Thus the letter

initially received as an ex parte communication has had a continuing ex parte and prejudicial effect upon this bankruptcy proceeding.

In view of the foregoing ex parte activities directly involving the Court on the crucial conflict of interest issue, we have moved the disqualification of the Judge in the proceeding brought by the Trustee to disqualify this firm, both of which motions are presently pending. This ground of disqualification is under 28 U.S.C.§455(b)(1). As stated in Wright, Miller & Cooper, Federal Practice and Procedure §3543, this provision " . . . is treated, both in the statute and in the provision of the Code of Judicial Conduct from which it is taken, as a part of the provision concerning bias or prejudice, on the theory that personal knowledge will affect the judge's ability to be impartial." (Footnote omitted.) Wright, Miller & Cooper add the further comment that has direct bearing on the circumstances described below (ibid.):

> "Although the statute calls for personal knowledge, the cases [before the 1974 amendments] had held that a judge was disqualified on the ground of bias or prejudice if ex parte communication had been made to him purporting to advise him of the facts of a case. That result should continue to be reached, under one or the other provisions of Section 455(b)(1)."

As quoted above, on August 18, 1976, the Court stated that he had the conflict issue actively under consideration (supra, p. 18). It was not until the hearing on the application

for the appointment of a receiver and the Chapter X petition on September 27, 1976, that we were told by the Judge, in an apparent reversal, that in his view the conflict of interest issue had not been properly raised. This ruling was reached despite the fact that (1) as stated above, the Judge had previously stated that he had the matter under active consideration and (2) the application for the appointment of a receiver specifically referred to the conflict of interest problem. However, we made a motion at the commencement of the hearing as follows (Manning App. 110):

> "MR. WISEHART: . . . I move to disqualify the Trustee and his Counsel from participating in that proceeding as I may move under Rule 7 in a hearing of the Federal Rules of Civil Procedure, and the ground on which I make that motion is contained in the appendix which you have received dealing with a conflict of interest question and with the additional factor that the Trustee and his Counsel have a self and personal interest in this matter so that they cannot be relied upon to adequately protect the interests of the creditors because their interest is to perpetuate their positions.
>
> The testimony and the record is clear that the Trustee lacks transportation experience and undoubtedly the change of this procedure to a Chapter X proceeding would result in a change in the administration of the Bankrupt estate."

Further, in the Opposition of the Petitioning Creditors to the Trustee's Proposed Findings, the Motion was repeated as follows (Manning App. 328-329):

"15. This firm has repeatedly stated that the Trustee should resign because of the conflicts of interest of the Trustee and his counsel. We were confident that if a determination on the conflict issue were made, after hearing, as we requested, the Trustee could be relied upon to do the right thing. This belief was based inter alia on the representations by the Trustee to this Court that he would not continue to serve if he did not have its continuing confidence, our knowledge of the Trustee, and repeated statements by the Court that it had the conflict problem under consideration. We have now learned, however, that the Trustee's counsel are taking the technical (and incorrect, in our view, considering the circumstances) position that the matter can and will be considered only on a motion to remove the Trustee. Further, at the hearing on September 27, 1976, we orally moved that the Trustee and his counsel be disqualified from opposing the approval of the Chapter X petition on grounds of conflict of interest and a specific adverse interest in that they have a financial interest in being perpetuated in office, which would be foreclosed by approval of the Chapter X petition and the appointment of an independent trustee by the District Court. Again, a technical objection was raised. So that there can be no confusion whatsoever, on behalf of petitioning creditors, said motion is hereby confirmed in writing, although we continue to maintain that it is not necessary to do so under the Federal Rules of Civil Procedure. Further, since it now appears that the Trustee intends to attempt to continue in office whether he has a conflict of interest or not, and because of the extended delay by the Bankruptcy Court in considering this matter, we hereby formally move that the Trustee and his counsel be removed from office, that an independent trustee be appointed by the Court, entirely apart from whether or not the Chapter X petition is approved for filing, and that Hon. John J. Galgay, Bankrutpcy Judge, recuse himself from acting on these motions in view of his personal involvement in the subject matter. [Emphasis added.]

16. Further grounds for disqualification and removal of the Trustee and his counsel are set forth in the affidavit of Robert E. Friou, Esq., annexed hereto, showing that the answer purportedly filed herein by debtor is false and fraudulent in that it lacks proper authority and in fact was not filed on behalf of debtor at all but instead was procured by the Trustee and one of his railroad-affiliated lawyers Donald L. Wallace,

Esq., who is also shown thereon as having witnessed the document as Notary Public. Said purported answer was obtained from a former REA employee dependent upon them for continuing employment."

Finally, the Trustee's brief contends that "There is neither statutory authority nor a logical need to inquire into the qualifications of the Trustee in a hearing on whether a Chapter X petition has been filed in good faith . . . . " (Br. 51)

This point of view would result in a perversion of the beneficial purposes served by the addition of Chapter X to the Bankruptcy Act so that the public interest aspects favoring reorganization and rehabilitation of debtors, as opposed to their liquidation, can be given effect. It surely is not consistent with those statutory purposes for the fate of an important public service to rest upon the views of a self-interested Trustee and his counsel chosen from among the ranks of railroad and airline competitors and defendants in major litigation who have been seeking its extinction for years.

We submit that the addition of the adverse interest grounds for the appointment of a receiver in Bankruptcy Rule 201 are designed with this very type of situation in mind.

Now that the entire proceeding has become a series of charges and countercharges about conflict of interest, with the Trustee's own motion to disqualify brought on against this firm following this appeal, but dealing with the same issues as the appeal, the necessity of the appointment of a receiver is all the more evident.

III

The Findings of the Bankruptcy Court Should be Disregarded

The Trustee's brief attaches great weight to the findings of the Bankruptcy Court. (Br. 15, 42, 43) In particular the Trustee relies upon a finding in support of the liquidation, as opposed to reorganization, purportedly based upon "the testimony of all witnesses and parties at all hearings since February 18, 1975." (Br. 43) The brief omits to cite even one bit of such testimony, however, and we are certainly aware of none. At the hearing at the time of REA's adjudication, indeed, Mr. Kahn specifically stated that "precisely to what extent [the Trustee] will continue what operation remains to be seen." (R. Nov. 15, 1975, p. 34.) The Rexco operations were continued thereafter, very profitably, until the Trustee's liquidation posture got him in trouble with the ICC, and on November 27, 1976, he discontinued the operation that was then producing profits of $2 million a year* -- a discontinuation which need not have taken place, particularly

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*At the hearing before Judge MacMahon, we stated that the Rexco operation was then producing profits of approximately $2 million per year. Judge MacMahon asked if that statement were true and Mr. Kahn, replied as follows (Manning App. 385):

"MR. KAHN: No, your Honor.

"At the time that the trustee took over its net profit from its inception was $35,000. After the trustee took over I think he lost money the first month, he made the money back the second month and since that time both the volume and the profit have increased." (footnote cont. next p.)

if the Chapter X petition had been entertained. This error is especially inexcusable in the context of the refusal to hear testimony regarding the possibilities for reorganization at the Chapter X hearing by a man of Mr. Nogg's stature and proven track record in successfully reorganizing transportation companies in bankruptcy (Yale Express, under the supervision of Judge Tyler, and Republic Carloading).

The findings of the Bankruptcy Court should be disregarded for the additional reason that they were not the work product of the Bankruptcy Court but of the Trustee's counsel.

(footnote cont.)

We submit that the foregoing is a clear and intentional misrepresentation of fact. The argument before Judge MacMahon took place on September 29, 1976. Only two days before that date, on September 27, 1976, the Trustee signed, through his counsel, an application for an extension of the Rexco operation through November 6, 1976 stating that (¶7): "At this time, the Trustee's estimate is that September gross revenues for four weeks will be $2,100,000 and September pre-tax profit will be about $147,000." A four-week profit of $147,000 would produce almost $2 million a year in profit, and Mr. Kahn must have known this at the time he responded as he did to Judge MacMahon's question. Further, in the order dated November 16, 1976, upon which a further extension of the Rexco operation was granted, it is stated that the November pre-tax profit would be approximately $182,000 -- substantially more than a $2 million profit on an annual basis! (REA would not have to pay income taxes on these profits if it were in a Chapter X reorganization, it is believed, because of the availability of the tax loss carry-forward of prior years.)

It was not to be expected, of course, that the Rexco operation would be as profitable at the beginning stages as later. But on page 157 of bankruptcy counsel's fee application filed January 18, 1977, the total profits from Rexco from the date of adjudication through November 1976 are listed as $1,174,277. We submit that Mr. Kahn's response to Judge MacMahon's inquiry demonstrates as well as anything can that the Trustee and his counsel cannot be relied upon to present the interests of the bankrupt estate in any kind of impartial way, and that an independent receiver should be appointed.

The circumstances are that the hearing before the Bankruptcy Court was held on September 27, 1976, at the conclusion of which, having failed to hear the testimony offered on behalf of the former employees, the Judge announced from the bench that he was going to "recommend" to Judge MacMahon that the Chapter X petition was not filed in good faith, and instructed counsel for the Trustee to prepare findings to be served upon counsel for the former employees by 4 p.m. the next day. (Manning App. 198, 199)

The proposed findings of fact were not served until after 6 p.m., and we called the Bankruptcy Court first thing the next morning to say that our comments in opposition would be hand delivered that day. However, about noon, after our comments had been sent to the Bankruptcy Court, we learned that there would be a hearing before Judge MacMahon that same afternoon. When we got there, we discovered that our comments on the proposed findings had not even been considered by the Bankruptcy Court (Manning App. 340), and that the findings adopted by the Bankruptcy Court were substantially as prepared by the Trustee's counsel. (Manning App. 321, 323)

It was not until the midpoint of the proceeding before Judge MacMahon that we saw for the first time the findings which the Bankruptcy Court had actually adopted (Manning App. 362). We noted that the findings were substantially as prepared by the

Trustee's counsel. When we pointed out to Judge MacMahon that they had evidently been prepared in an office of someone other than the Bankruptcy Court, the observation was shrugged off with the comment that (Manning App. 362):

> "MR. WISEHART: We think it is inappropriate that these [findings] be prepared in an office in which the conflict of interest issue is involved and adopted by Judge Galgay as such. On that particular issue --
>
> "THE COURT: That's a mere matter of clerical labor."

As stated in Wright and Miller, Federal Practice and Procedure §2576, "The practice of verbatim adoption of counsel's findings is now viewed with disfavor." (Footnote omitted.) That view has firmly been adopted in this Circuit. In Matter of Flora Mir Candy Corporation, 432 F.2d 1060 (2d Cir. 1970), an appeal from a District Court's reversal of a Bankruptcy Court decision consolidating several proceedings was involved. This Court noted that the referee (now called a Bankruptcy Judge) had signed the findings proposed by the attorneys for the debtors "without any material change" (432 F.2d at 1062). Noting that "We have frequently noted our disapproval of this practice . . .," and citing numerous authorities (id. at fn. 2), this Court sustained the reversal by the District Court on the ground that the evidence before the Bankruptcy Court had been "grossly insufficient." (Ibid.)

When as here, the findings were adopted without giving consideration to the comments of opposing counsel, it is the same as if the findings were adopted without notice to opposing counsel, and the following comment becomes applicable: "That practice involves the failure of the trial judge to perform his judicial function and when it occurs without notice to the opposing side, as in this case, it amounts to a denial of due process." Chicopee Mfg. Corp. v. Kendall Co., 288 F.2d 719, 724-725, cert. denied, 368 U.S. 825.

IV. Findings That Were Not Made

A. One finding which the Bankruptcy Court did not make in the Chapter X proceeding, but which the Trustee nevertheless attempts to rely on, is that the hearing on the REAEMCO proposal was stipulated to be the entire record in support of the Chapter X petition (Br. p. 15). This refers to a finding made after the Alltrans/REAEMCO hearing, and it is an issue on appeal before Judge Werker that is still pending. Reliance on that contention therefore is highly improper. Further, it misstates the record of that hearing. Rather than stipulating as claimed, the following colloquy took place on the last day of the hearing (R. July 9, 1976, pp. 106-107):

"MR. WISEHART: I would like to reserve some time, Your Honor, on the Chapter X petition which we submitted --

THE JUDGE: Submitted but not filed.

MR. WISEHART: But submitted for your consideration for filing.

MR. KAHN: Your Honor --

MR. WISEHART: Subsequent to hearing the trustee's comments.

MR. MARCUS: I will object to that.

MR. KAHN: You have no authority, Your Honor, to read a petition which is not filed as yet.

THE JUDGE: I will not hear any argument under Chapter X."

When the same contention was made in the hearing on the Chapter X petition, the Judge asked the Trustee's counsel to point to where in the record there was any such stipulation, and he was unable to do so. (Manning App. 110-116) The Court's findings after the Chapter X hearing therefore contain no reference to such a stipulation. But while the Court made no such finding, it acted procedurally as if it had done so, and heard no evidence whatsoever at the Chapter X hearing. This violated the specific command of Section 143 of the Bankruptcy Act (11 U.S.C. § 545) that, in the event there are disputed material allegations of fact involving a Chapter X petition, the Court must determine the issue of whether "the material allegations are sustained by the proofs . . . " (Emphasis added.)

No proofs having been taken, the action of the Bankruptcy Court should be considered in the same light as on a motion to dismiss, treating all of the allegations of the verified petition as true.

B. A second contention made by the Trustee that does not take the form of a finding is that the reorganization of REA would take $10 million in capital. (Br. 44)

However, it is undisputed that the figure of $3 million which constituted a part of the REAEMCO proposal is one which

the Trustee himself had accepted as being adequate as part of the proposal he agreed to at the meeting of April 20, 1976. Indeed, in the Trustee's brief in the undecided appeal before Judge Werker, the following statement appears (p. 3):

> "At the court hearing, appellant REAEMCO made much of the fact that its proposed offer to the Trustee for the transfer of the operating authorities preceded the Alltrans offer and that the Trustee had encouraged counsel for REAEMCO to prepare such an offer, and indeed, had worked very closely with REAEMCO in the preparation of its offer. The Trustee readily admits all of these facts, and further acknowledges that his own general counsel assisted REAEMCO in conceptualizing the REAEMCO proposal."

In actual point of fact, Mr. Nogg's testimony was that far less than $3 million working capital would be required at the outset -- that the amount presupposed expeditious re-activation of express services. (R. Jul. 9, 1976, p. 125.)

Also testifying at the REAEMCO hearing was Dr. James R. Nelson, the Charles E. Merrill Professor of Transportation Economics at Amherst College, a consultant to federal and state transportation agencies, a Rhodes Scholar with a Ph.D. from Harvard, who said that in his opinion the working capital requirement would not be great, and that the employee ownership feature with labor rates set to produce a guaranteed profit at a 95 percent operating ratio was very likely to be successful in view of the labor intensive nature of transportation. (R. July 8, 1976, pp. 170-226)

Similar testimony was given by Mr. Selig Altschul, President of Aviation Advisory Services, Inc., a leading transportation writer and consultant. (R. July 1, 1976, pp. 47 et seq.)

Finally, at the Chapter X hearing both Mr. Nogg and Mr. Devlin offered to testify on the distinct possibility of federal funding, but the Court inexplicably would not listen. (Manning App. 134, 139-140)

In response to all of this, the Trustee offered not one word of testimony. Further, his position in this proceeding is discredited by the memoranda prepared at his request, by qualified transportation executives, Messrs. Miller and Kole, showing that reorganization is feasible. The Trustee suppressed these memoranda from the record in this case, and Judge Galgay refused to consider them although they directly impeach the Trustee's credibility. They are set forth in the Manning App. 202 and 212.

At the hearing on the REAEMCO proposal, the Trustee himself made an admission which we submit alone is adequate to satisfy the Chapter X good faith requirement. (R. July 9, 1976, p. 171):

> ". . . I felt that the proposed operation, with adequate capital, would have a fairly good chance of succeeding."

The existence of the Alltrans proposal in addition to the REAEMCO proposal -- indeed, there were two other parties seeking REA's rights at the hearing -- shows that a profitable reorganization <u>is</u> possible, not the contrary. Substantial interests were in agreement at the hearing that REA's authority <u>can</u> be operated profitably, and that the express business would return. The inconsistency in the Trustee's present position is shown by the following statements which he filed at the ICC in conjunction with Alltrans:

> ". . . although the Trustee curtailed full-spectrum express service on November 6, 1975, he was, as recently as May 15, 1976, receiving 150 local requests every day for such service at his New York office. Even today, nearly 9 months since curtailment, and despite a change of office address and new phone numbers, he is still receiving approximately 50 calls per day for such service. Each such requester was informed of the service curtailment, so that each call represents a separate citizen desiring service from that single city. Thus, some 25,000 separate non-commercial shippers from that one city, who were not aware of the curtailment, have unsuccessfully called for express service. Other REA offices had similar experiences. [V.S. Sowerwine]
>
> By letter mailed about August 15, 1976, transferee Alltrans Express U.S.A., Inc. informed a relatively small portion of REA's former customers that Alltrans was seeking authority to immediately resume and preserve REA's nationwide full-spectrum express service for all sizes of shipments, and suggested that, if such resumption and preservation is important to them, they send applicant a letter addressed to the Commission, so stating and giving their reasons. * * *
>
> In instantaneous response, more than 1,900 shippers -- one of the largest public expressions of demand in the history of the Commission -- immediately took the time and trouble to send letters -- in all, nearly two feet thick -- strongly declaring their urgent and immediate need for such restoration...."

The fact that reorganization was sought would not necessarily have precluded the Alltrans proposal any more than the REAEMCO proposal or any other proposal. What it would mean, however, is that any such plan would have to be developed by a truly independent trustee, one presumably who knows something about transportation, with the participation of the Interstate Commerce Commission and the S.E.C. to represent the public interest (under Bankruptcy Rule 10-303(b) and (g), such participa-

tion by both agencies would be required), and the creditors themselves, rather given a death sentence by those who have a self-interest in opposing a Chapter X proceeding because it would bring an end to lucrative positions.*

It is contended by the Trustee that the loss preceding REA's adjudication should properly be computed at $19 million. (Br. 29) Again, no testimony was permitted on this (Manning App. 364), but the pre-adjudication period is irrelevant in any event because it includes at least $19 million in strike losses and employment benefits not paid, and fails to reflect elimination of fixed expenses and operations under a labor agreement producing a variable labor cost with a 95% operating ratio.

Finally, the Trustee's brief contends that the pending action of the ICC threatening to terminate REA's authority is not relevant in this appeal. (Br. 54-56) It is difficult to imagine what could be more relevant in view of the repeated warnings given to the Trustee by Mr. Nogg that his failure to go into Chapter X was placing REA's authority, its greatest asset, in serious jeopardy. References to the testimony are at p. 59 of our initial brief. Mr. Sowerwine's disregard of those repeated warnings has indeed had the predicted result. The authority may still be saved, however, by expeditious action. As noted above, the ICC would be a required party in a Chapter X proceeding (it is not now a party before the Bankruptcy Court). Further, the additional powers conferred upon a reorganization court by

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*The Trustee has sought $100,000 in interim allowances for a half-time job for approximately a year and bankruptcy counsel are seeking an interim payment approximately $800,000 at a hearing on February 18, 1977, amounts which inevitably appear, to thousands of out-of-work employees and creditors, grossly disproportionate rewards.

Chapter X would be available including the power to stay an administrative proceeding which is inconsistent with the pending efforts at corporate reorganization. See Bankruptcy Rule 10-601(a), and the leading case of In re Otis & Co., 104 F.Supp. 201 (N.D. Ohio 1952).

V. The Standard Applicable to Chapter X Petitions is Not as Stated in the Trustee's Brief, and His Conjectures As to Appellants' Proof Are Entitled to No Evidential Weight

The Trustee's brief misstates the law applicable to proceedings under Chapter X of the Bankruptcy Act. There is no case cited by the Trustee which has any reasonable bearing upon the possibility of reorganization in REA's situation with transportation rights admittedly worth a potential $50 to $100 million. Further, it should be noted that the law specifically contemplates that a Chapter X petition may be filed after adjudication as well as before. Section 127 states (11 U.S.C. § 527):

> "A petition may be filed in a pending bankruptcy proceeding either before or after the adjudication of the bankrupt."

Under Chapter X an orderly two-step procedure was enacted as distinguished from the sudden death structure of old Section 77B. The first step is the filing of a petition which raises only the question of the possibility of reorganization. At that stage all that is required is that it not be unreasonable to expect that the corporation may be reorganized. Not until the second step, after the Chapter X petition has become operative, is the plan of reorganization itself developed and submitted to the creditors for their approval.

In In re Business Finance Corporation, 451 F.2d 829 (3d Cir. 1971), the Court said:

> "It is unnecessary that the Chapter X petitioner prove at the outset the fairness and feasibility of possible plans or reorganization.
>
> With respect to the good faith requirement of Section 146(3), approval of a Chapter X petition should not be withheld 'unless it is abundantly clear that there is no possibility that a plan of reorganization can be effected' and 'any doubt as to whether a plan can be effected should be resolved in favor of the approval of the petition.' (Emphasis added.)

In the above case, the Court also quoted with approval the standard expressed by the Fifth Circuit in A-Cos Leasing Corporation v. Wheless, 422 F.2d 522 (5th Cir. 1970):

> "The whole scheme of Chapter X indicates that this [good faith] test should not bar approval of a petition unless it is abundantly clear that there is no possibility that a plan of reorganization can be effected. In other words, the Court should be 'reorganization minded' and not 'liquidation minded.' Any doubt as to whether a plan can be effected should be resolved in favor of the approval of the petition, as some corporations whose affairs have seemed hopeless at the outset have undergone successful reorganization. In other words, the provisions of Chapter X should be given a sympathetic construction consonant with the relief intended." (Emphasis added.)

See also Grubbs v. Pettit, 282 F.2d 557 (2d Cir. 1960)

> ("It is well settled that the petition need not contain a specific plan of reorganization. The petitioner need only demonstrate that there exists a reasonable possibility of successful reorganization."), and the extensive discussion in In re Southern Land Title Corp., 301 F.Supp. 379, 409 (E.D.La. 1968).

As stated in Collier on Bankruptcy ¶6.09:

> "Those interested in securing a reorganization should be given an opportunity to work out a plan so long as there is any reasonable expectation that such result may be accomplished, even though opposing interests claim in advance that any plan proposed will be futile."

CONCLUSION

The decision below should be reversed. The case should be remanded with instructions to take immediate action to entertain the application to appoint a receiver, and for further proceedings on the Chapter X petition.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The foregoing Reply Brief was served by mailing two (2) copies therof to all counsel of record at the addresses below this 15th day of February, 1977.

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